No. 15888

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

FRANK W. BABCOCK,

Respondent.

RESPONDENT'S BRIEF.

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Statement.

Respondent does not quarrel with the Statement of Petitioner except insofar as it says that the taxpayer executed a *mortgage* and that the State, in the condemnation proceedings paid certain moneys to the *mortgagee.* [R. 3.]

In fact, as shown by the stipulation of facts [R. 23, par. 5], Exhibits 4-D [R. 27, par. 3] and 5-E [R. 33, par. 3] the document executed was a purchase money trust deed. The Tax Court recognized this fact [Opinion, R. 7, second par.] but chose to rest its decision upon grounds unaffected by the distinction between a California purchase money trust deed and a mortgage. As we shall develop, California property law is such as to make it important that taxpayer executed a purchase money trust deed.

Question Presented.

Whether or not the interest of a California Trustor in real property as to which a purchase money trust deed was executed is the "property" which was "converted into money" in a condemnation proceeding so that where all of the money into which it was converted was reinvested in property "similar or related in use or service" no gain on an involuntary conversion should have been recognized and no deduction or adjustment should have been made as a result thereof to an established net operating loss for the year following the involuntary conversion?

Statement of Points to Be Urged.

The decision of the Tax Court was and is correct.

Interests of the trustor and of the beneficiary in the real property involved in the involuntary conversation were several interests in real estate. Each of the several interests was converted into money. All of the money into which the trustor's (Respondent's) property was converted was reinvested in property similar or related in use or service to the property converted. No gain should have been recognized by the Commissioner and no adjustment should have been made to Petitioner's net operating loss in the ensuing year as the result of this transaction.

C. I. R. v. Fortee Properties, Inc. (C. A. 2), 211 F. 2d 915, was wrongly decided and is not controlling or persuasive.

ARGUMENT.

A. The Interests of Trustor and Beneficiary in the Real Property Involved Were Separate Interests in Real Estate and Were Separately Converted Into Money.

Under the law of the State of California trustor and beneficiary in a transaction involving a conveyance of land and the co-terminous execution of a note and purchase money trust deed are co-owners of interests in real estate.

> ". . . the seller who takes back only a note secured by a trust deed has nothing to which he can resort but the land *and in a real sense has converted his entire ownership into a lesser interest in the real estate.* The conveyance to the buyer and the purchase money trust deed cannot be divorced; they come into being simultaneously and must be viewed realistically as a single transaction."
>
> *Moore's Estate,* 135 Cal. App. 2d 122, 286 P. 2d 939, 944.

The position of trustor and beneficiary is thus analogous to that of tenants in common in real property whose several interests may be, in a condemnation proceeding, "property" which is "converted into money." (I. R. C., Sec. 112(f)(2), 26 U. S. C. (1952 Ed.), Sec. 112(f)(2).)

What does the interest of the trustor in such a transaction consist of? He has received, and has conveyed to the trustee the legal title to the property; he has the right of possession, the right to receive and retain the rents, issues and profits, and the right either to complete the purchase or to abandon the transaction without personal liability for any balance of purchase price.

We concede that depreciation allowances are based upon the cost of the property, undiminished by the amount of unpaid purchase price, whether secured by mortgage or otherwise. This is done because the statute says it shall be done. (I. R. C., Sec. 113(a); 26 U. S. C. (1952 Ed.), Sec. 113(a).) But the *cost* of the trustor's limited interest is the full purchase price to be paid if he exercises his right to complete the purchase, not the down payment he may, or may not make. Hence there is no incongruity in the trustor's having taken a depreciation allowance relatively large in comparison to his down payment.

This Court has recognized that the word "property" as used in the Internal Revenue Code, may, depending upon the circumstances of the case, comprise less than complete legal and equitable title. See *C. I. R. v. Moore* (C. A. 9), 207 F. 2d 265, at 268, column 2, where the Court said:

> "But 'such property' is not the steel frame, brick and terra cotta loft and store building on the corner of Figueroa, Seventh and Flower Streets in the City of Los Angeles,—it is the taxpayer's interest in that property. And her interest is a limited one, not only because it is a fractional part, but also because it is subject to the lease . . ."

This Court has, as did the California court in *Moore's Estate, supra,* recognized the fact that a trust deed beneficiary has, under California law, a proprietary interest in real property which interest may be considered and determined in a condemnation action.

Thibodo v. United States (C. A. 9), 187 F. 2d 249, 256;

Bullen v. De Bretteville (C. A. 9), 239 F. 2d 824, 830.

Viewed in the light of these principles the separate properties of trustor (Respondent) and of the beneficiary were each, severally converted into money in the condemnation proceedings. Respondent received $149,750.71 for his "property" and reinvested all of it in property similar or related in use or service and no gain should have been recognized. The decision of the Tax Court in this case was correct and should be affirmed.

B. C. I. R. v. Fortee Properties, Inc. (C. A. 2), 211 F. 2d 915, cert. den. 348 U. S. 826, 75 S. Ct. 43, Was Wrongly Decided by the Second Circuit Court of Appeals.

We think that the Second Circuit was in error in considering that the *Fortee* case was governed by *Commissioner v. Crane,* 331 U. S. 1.

All that was involved in *Crane* was a determination that, under the circumstances of the case, in order to arrive at the taxpayer's true capital gain, it was desirable to treat the principal of the unassumed mortgage as so much cash received on the sale. In substance the decision only amounts to saying that between the acquisition and sale of the property the taxpayer's capital account had increased in an amount equal to the depreciation taken by the taxpayer during her ownership plus the $2,500.00 which she received at the time the property was sold.

The real question involved in such cases is: "What was the economic gain realized by the taxpayer?" This is illustrated by *Woodsam Associates Inc.,* 16 T. C. 649, aff'd 198 F. 2d 357, where an identical result is reached either by treating the mortgages as cash received or by

analyzing its capital account. The following tables show the two types of computation:

Commissioner's Computation

Mortgage in 1943		$381,000.00
Less: Adjusted basis		
Original Cost	$296,400.00	
Improvements	1,541.90	
Depreciation	(63,000.00)	234,941.90
Gain		$146,058.10

Analysis of Capital Account

Money derived from loans secured by the property during ownership	$212,500.00
Less: Principal of loans repaid	26,500.00
Net increase in cash position from loans	186,000.00
Return of cash down payment and cost of improvements	102,941.90
Overall increase in cash position	83,058.10
Capital returned by way of allowance for depreciation	63,000.00
Gain	$146,058.10

Similarly in the case at bar the gain resulting from the conversion is the same whichever method is used.

(a) Sale Price, including trust deed balance, *arguendo,*		$207,323.34
Less: Adjusted Basis		
Original Cost	$89,600.00	
Depreciation	(8,000.00)	81,600.00
Gain		$125,723.34

(b) Cash received in condemnation	$149,750.71
Less: Principal of purchase price paid	12,427.37
	137,323.34
Return of cash down payment	19,600.00
	117,723.34
Capital returned by way of depreciation allowance	8,000.00
Gain	$125,723.34

Thus in the case at bar we see that it is unnecessary to consider the unpaid balance of the trust deed as cash received in order to determine "the economic gain realized by the taxpayer." (*Woodsam, supra,* p. 655.)

Before analyzing the effect of *Internal Revenue Code,* Section 112(f)(2), upon the transaction in the case at bar it is well to point out that Section 111 relating to realization of gain and Section 112 do not always run hand in hand. In other words, if there is no gain under Section 111 as the result of an involuntary conversion, then it is immaterial how much cash was received or what was done with it. The mere fact, therefore, that it is convenient to include a mortgage debt as cash in the determination of gain does not require that the mortgage be regarded as cash for all purposes.

What is the real purpose of *Internal Revenue Code,* Section 112(f)(2)? It is to make sure, as a condition of non-recognition of gain, that a taxpayer's entire investment in the converted property, including his eco-

nomic gain, is transferred into property similar or related in service or use to the property converted. In the case at bar this result has been accomplished:

Down payment	$ 19,600.00	
Principal payments	12,427.37	
	32,027.37	
Less: Capital returned by way of depreciation	8,000.00	Amount reinvested
	24,027.37	in similar
Gain	125,723.34	property
Capital investment plus gain	$149,750.71	$149,750.71

There can be cases, similar to *Woodsam, supra,* in which it would be necessary or desirable to treat the amount of a mortgage as cash received in order to arrive at a proper result. For instance, suppose that property fully paid for and having a market value of $207,000.00 and an adjusted basis of $82,000.00 has been mortgaged to secure payment of a cash loan of $57,000.00 the proceeds of which have been received by the taxpayer. The property is then condemned, and $207,000.00 paid, $150,000.00 to the taxpayer and $57,000.00 to the mortgagee. In such a case the entire capital investment and gain has not been reinvested if only the $15,000.00 cash received from the condemnor is reinvested.

The same would be true if the mortgagor were personally liable and his assets were freed to the extent of $57,000.00 by the payment of the mortgage in the condemnation proceedings.

In the case at bar the taxpayer was not personally liable for the balance unpaid under the trust deed.

Cal. Code Civ. Proc., Secs. 580b and 580d.

Hence, no assets were freed by the payment of the trust deed balance in the condemnation proceedings, and no money or property or value was received by the taxpayer other than the sum of $149,750.71, all of which was reinvested in similar property.

See: *Harper v. Heizer,* 103 Cal. App. 2d 388 at 390, in which appellant claimed that she had contributed value by signing a purchase money trust deed. *Held:* To the contrary; she suffered no detriment by executing the trust deed.

The whole purpose of *Internal Revenue Code* Section 112(f)(2) is to prevent the taxpayer from being required to pay a tax with respect to a capital gain which he has not sought, and may actively resent, which has been forced upon him by the irresistible power of a governmental agency, unless he chooses voluntarily not to reestablish his position. In cases such as *Fortee,* and the case at bar, the taxpayer cannot reinvest money that he does not and cannot receive.

In *Fortee,* the Second Circuit Court, to try to avoid the logic of the argument that since the taxpayer was not personally liable, no assets were freed by the satisfaction of the mortgage, and therefore no gain was realized, forced the issue by saying that as a practical matter

> ". . . the taxpayer-mortgagor has to treat the obligations of a non-assumed mortgage as if they were his personal obligations. Payment to the mortgagee relieved the owner of this necessity."

This attempted justification was forced only because of a felt necessity to carry over into *Internal Revenue Code,* Section 112(f), a concept, useful but not necessary, used in determining the existence of a capital gain under *Internal Revenue Code,* Section 111.

On the side of the taxpayer, using the Second Circuit's approach, we might well force the issue the opposite way by saying as a practical matter that ". . . the taxpayer-mortgagor has to treat the money actually received by him in the condemnation proceeding as *all* of the money available for reinvestment." In other words, how can a taxpayer invest money which he does not receive or control? And, is Section 112(f)(2) to be regarded as a device to add additional financial burdens upon property owners who have not fully paid for their properties while those who have fully paid, and who are financially better off, can avoid the impact of the tax entirely?

C. The Tax Court's Decision Is Not Contrary to the Cases Cited by the Commissioner nor Is It Contrary to the Regulations and Interpretations of the Commissioner.

In all of the cases cited by the Commissioner, except *Fortee,* distinguished above, the taxpayer actually received or had some control over the moneys which eventually were used for something other than reinvestment, or alternatively, by means of loans on the property while it was owned by him money were derived and spent for purposes other than reinvestment. We do not quarrel with the result in any of these cases except *Fortee.*

We think that it is this sort of thing that was contemplated by the Commissioner's regulations and inter-

pretations and not the situation in the case at bar for, as the Tax Court said [R. 12]:

> ". . . If his (the Commissioner's) regulation is intended to cover a case like this one in which the petitioner was not personally liable for the mortgages, then to that extent the regulation is invalid because it frustrates rather than promotes the intention of Congress."

Conclusion.

In conclusion, we see that the petitioner's several interest in real estate was converted into money, all of which was reinvested in similar property, and, in any event, the purpose for which *Internal Revenue Code* Section 112(f)(2) was enacted has been fully satisfied, regardless of which approach to the problem is used. The decision of the Tax Court in the case at bar was correct and should be affirmed.

Respectfully submitted,

Austin Clapp,

Attorney for Respondent.

APPENDIX.

Internal Revenue Code of 1939:

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113(b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount Realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

* * * * * * * * *

(26 U. S. C. (1952 Ed.), Sec. 111.)

SEC. 112. RECOGNITION OF GAIN OR LOSS.

* * * * * * * * *

(f) [as amended by Sec. 151(d) and (e) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Involuntary Conversions.*—If property (as a result of its destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation, or the threat of imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, or into money which is forthwith in good faith, under regulations prescribed by the Commissioner with the approval of the Secretary, expended in the acquisition of other property similar or related in service or use to the property so converted, or

in the acquisition of control of a corporation owning such other property, or in the establishment of a replacement fund, no gain shall be recognized, but loss shall be recognized. If any part of the money is not so expended, the gain, if any, shall be recognized to the extent of the money which is not so expended (regardless of whether such money is received in one or more taxable years and regardless of whether or not the money which is not so expended constitutes gain).

* * * * * * * * *

(26 U. S. C. (1952 Ed.), Sec. 112.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * * * * * *

(26 U. S. C. (1952 Ed.), Sec. 113.)

Section 580b, Code of Civil Procedure for the State of California, provides as follows:

"No deficiency judgment shall lie in any event after any sale of real property for failure of the purchaser to complete his contract of sale or under a deed of trust, or mortgage, given to secure payment of the balance of the purchase price of real property.

"Where both a chattel mortgage and a deed of trust or mortgage have been given to secure payment of the balance of the combined purchase price of both real and personal property, no deficiency judgment shall lie at any time under any one thereof."

Section 580d, Code of Civil Procedure for the State of California, provides in part as follows:

"No judgment shall be rendered for any deficiency upon a note secured by a deed of trust or mortgage upon real property hereafter executed in any case in which the real property has been sold by the mortgagee or trustee under power of sale contained in such mortgage or deed of trust. * * *"